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No. 91-

IN THE

Supreme Court of the United States

October Term, 1991

MORGAN CASHMAN,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondents.

**PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT**

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QUESTIONS PRESENTED FOR REVIEW

1. Can unrelated setoff items be utilized by the Government when they are barred by the statute of limitations?
2. Can refunds claimed on account of unquestioned net operating loss carrybacks reopen the carryback years for unrelated setoff items?
3. Do the Federal Courts have the power to enact a rule allowing unrelated setoff items in tax cases in the absence of a statute?
4. Under Rule 15 of the Federal Rules of Civil Procedure, may the lower courts allow unpled setoff defenses without allowing discovery to defend such claims?
5. What is the definition of "sham" for tax purposes in business loss cases?
6. Is the question of whether a transaction is a "sham" is a question of law or fact for Appellate review?
7. Is the Internal Revenue Service unconstitutionally regulating the publishing and entertainment industries by the disallowance of business losses?

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OPINIONS BELOW

None of the opinions or Orders of the Courts below were published. They are set forth in the following appendices:

Appendix A: District Court Order denying motions for summary judgment

Appendix B: Findings of fact and conclusions of law — District Court

Appendix C: Court of Appeals Order consolidating Harris Cashman, Docket #91-834

Appendix D: Memorandum opinion of the Court of Appeals

Appendix E: Court of Appeals Order denying petition for rehearing

JURISDICTION

Jurisdiction is invoked under Section 1254 of Title 28 USC. Jurisdiction in the District Court involved a claim for refund of income taxes under Section 7441 and 7442 of the Internal Revenue Code. The decision was affirmed on May 2, 1991. A timely petition for rehearing was denied on September 20, 1991.

STATUTES INVOLVED

IRC § 1311.

IRC § 1314.

FRCP Rule 15(b).

(See Appendix F *infra*.)

STATEMENT OF THE CASE

This petition concerns a decision by the Court of Appeals Ninth Circuit affirming a judgment of the United States District Court for the District of Nevada denying an income tax refund. The claim for refund arose from a net operating loss in the year 1982. The loss resulted from the taxpayer's operation of a business in Atlantic City, New Jersey. This loss was never questioned by the Internal Revenue Service, nor was the loss disputed in the United States District Court. Because of the mechanics involved in computing net operating loss carrybacks, refunds were claimed for the years 1976, 1977, 1978, 1980 and 1981. There was no claim for refund in the year 1979.

The dispute in this case solely involves three setoffs belatedly claimed by the United States in defense of the admitted credit for the 1982 net operating loss. The first setoff involved losses of the taxpayer from his investment in a paperback romance novel published by a reputable New York publishing house known as Zebra Books. This loss was claimed for the tax years 1978 and 1979. The second setoff

involved a limited partnership known as Dover Collection. The partnership marketed a large number of books in diversified fields, published by reputable and well known publishers who were considered experts in their field, and included such famous or infamous authors as Winston Churchill, Arthur Schlesinger, and E. Howard Hunt. The losses for Dover were only deducted on the taxpayer's 1979 return, which was not the subject of a refund claim in the United States District Court. The third loss claimed as an offset by the Government involved the purchase of country music videotapes by prominent and popular country-western singers, the producer of which also being experienced and well known in the country music field. The taxable year in question was 1980.

The first two questioned business losses were similar and identical to the losses disallowed in the companion case which is presently before this Court: *Harris Cashman vs. Commissioner*, Docket #91-834. The publisher of the romance novel was the same, but the book was different and went through two rather than three printings. The limited partnership was identical. Since the validity of these losses involved the same legal issues, the Ninth Circuit consolidated both cases for briefing purposes and ordered the cases be submitted to the same personnel of the Court of Appeals. This Order is incorporated as APPENDIX C in this brief.

In the instant case, the Internal Revenue Service failed to assess any deficiencies for the years 1978 and 1979, and by the time of trial deficiencies for all years (including 1980) were barred by the statute of limitations. The complaint was filed on January 16, 1985 and the answer was filed on March 19, 1985. The answer did not claim as a counter claim or affirmative defense, a setoff or offset on account of any of the investments listed above, nor was a counter claim or affirmative defense or amendment of pleadings under Rules 13 and 15 of the Federal Rules of Civil Procedure ever filed or claimed by the Government.

On March 25, 1986, approximately 15 months after the filing of the complaint, the Government moved for leave to file a counter claim for the 1980 country music videotapes loss deduction. This was granted but the counter claim was never served on plaintiff, and the counter claim was dismissed on the Government's own motion on November 30, 1988.

In brief, at the time of trial, no setoff defenses were raised in the pleadings, neither formally nor informally by amendment under Rule 15 of the Federal Rules of Civil Procedure. Petitioner has at all times claimed that these defenses were barred by the statute of limitations.

For the Court's convenience because the principal question for review involves the statute of limitations and because of the net operating loss carryback involves a number of taxable years, we set forth the following graph:

GRAPH OF TAXABLE YEARS AND ISSUES INVOLVED

	1976	1977	1978	1979	1980	1981	1982
Statute of Limitations	barred	barred	barred	barred	barred	barred	barred
Net Setoff Claim	no issue	no issue	Triumph	Dover Triumph	Video	no issue	no issue
Refund	refund	refund	refund	no refund	refund	refund	net operation loss
Net Operating Loss Carryback				1979	1980	1981	1982
Investment Credit Carryback	1976	1977	1978	1979			
Net Operating Loss Carryforward				1979	1980	1981	
Investment Credit Carryforward	1976	1977	1978				

It should be noted that the only possible collision of the deficiencies urged by the Government and the refund claims are in the years 1978 and 1980, a crucial and relevant fact that the District Court and the Court of Appeals refused to address since as a consequence petitioner would have been entitled to a refund for 1976, 1977, 1981 and 1982.

The Department of Justice originally agreed with petitioner that the two book investment deductions were not an issue at the trial because the statute of limitations barred them. The Government so stated in the joint motion for reopening discovery which was filed August 26, 1987. Neither party under the circumstances undertook discovery on this issue. In the companion case a thorough and complete *joint* stipulation of fact had been made by the Government and filed with the Tax Court.

In the District of Nevada under local practice orders, the Court sets a cutoff date for discovery and a date for submission of a joint pre-trial order. Commencing in August 1985, the parties entered into six stipulated joint motions for extensions of discovery and the joint pre-trial order. These extensions were required because (among other things) some seven different Justice attorneys were successively involved in this case. On November 6, 1986, the last of the changing attorneys for the Department of Justice requested petitioner's counsel to stipulate to an extension order so he could familiarize himself with the file. A stipulated motion to this effect was prepared by the Department of Justice attorney. Petitioner's counsel signed it without realizing that under the terms of the stipulation discovery was not extended.

On November 23, 1987, the United States made a motion for summary judgment and for the first time raised the issue of the disallowance of the business losses claimed on the 1978 and 1979 returns. Shortly thereafter petitioner cross-moved for summary judgment on the grounds that the net operating loss of 1982 was not questioned and the defenses

urged were barred by the statute of limitations. The summary judgment motions were not decided until six months later in July 1988.

At the time of the decision on the motion for summary judgment, discovery had been cut off by the District Court's order of October 20, 1987. The joint stipulation of fact on the book investments entered into in the companion case of Harris Cashman in the Tax Court was utilized by the Government in its summary judgment motion and included the Department of Justice's motion for summary judgment by way of affidavit. In preparation for the joint pre-trial order, however, the Justice attorney refused to agree to any of this documentation being admitted without proof of authenticity, although it requested that all of the same documents be admitted without objection in the Government's case. It is to be noted that all the witnesses as to fact and documentation in the case of the book investments were residents of New York.

Three separate motions to reopen discovery were denied, commencing on December 19, 1988 and ending at the date of trial on May 11, 1989. The Government's affidavit in their very own summary judgment motion was offered at the trial by petitioner, but the offer was denied by the Court. The same documentation was utilized by the Government's only substantive witness (the so-called expert), and petitioner moved that this documentation be admitted into evidence; this motion was denied.

It's to be noted that the only substantive witness supporting the Government's case was the so-called expert, and the District Court in deciding in favor of the Government only relied on the *lack* of documentation in the plaintiff's case and the *opinion* evidence of the Government's so-called expert. We question whether a minute documentation of the details of the book transactions was relevant to the issue of whether or not the investments were a "sham."

Despite the denial of discovery, petitioner did get into evidence that the author of the book "The Triumph", Arthur Moore, had at least 15 books published and was published by Popular Library, Pocket Books, Future Publications, Pinnacle Books, Pocket Arts, Fawcett Publications and of course Zebra Publications. We established, also, that the publisher was reputable and well thought of in the industry; even the Government's experts so admitted. The uncontroverted facts in this case seem to require the same finding as was made by the Tax Court in the companion case of *Harris Cashman*, presently before this Court.¹ Based on these facts, finding a "sham" transaction seems to distort that word into a caricature of its recognized meaning.

To be sure, the Government's expert had a very negative impression of the book. It apparently was the very antithesis of her taste in literature. Perhaps this distaste could be explained by her background. The witness received a Bachelor's and Master's degree in organic chemistry sometime prior to 1947. She was a paralegal, graduating from New York University, and went into the publishing industry in 1947. Until about 1970, she appears to have worked for textbook and Protestant Sunday School publishers. From that time until 1980, she worked for the publisher of trade books. The witness was one of a large group of so-called experts, employed by the Internal Revenue Service on a contract basis to evaluate literary works for the purpose of determining whether or not loss deductions could be taken under Section 165 of the Code or disallowed on the basis of Section 183. Given the harsh economic reality of publishing and its speculative nature, she was in a word one of the Government's censors. And a very well paid one as well; she testified she was charging for her testimony in this case from \$20,000

¹ The Tax Court found that "publishing and distribution of the book was a "bona fide activity." The Court further found that the transaction was "bona fide", that the books were published and distributed, and that the publisher/distributor were recognized as established companies in their trade."

to \$30,000. Given the three to five cases a year for which she testified that would give her an income of from \$60,000 to \$150,000 a year.

The Court's decision on the country music videotapes was also based on the witness' so-called expertise, despite the fact the witness had no experience in bar entertainment, country western music sales, music video sales, home video sales, or any personal knowledge of any consequence of any popular music or bar entertainment. She had however produced one video for use in Sunday Schools which was entitled "Six New Testament Walks in Jerusalem."

The country music videotapes were produced by a recognized expert in the promotion of country western music who was personally and professionally known by the taxpayer's principal advisor, his accountant. The country western artists were conceded by the so-called expert witness to be well known and popular in the genre. The investment was not accompanied by an oversized, non-recourse note — it was made solely in cash and by a recourse note which, for tax purposes, is a cash equivalent. The District Court's standards for finding a "sham" under these circumstances is also questionable.

The Ninth Circuit on the basis of *Lewis v. Reynolds*, supra, affirmed the District Court's allowance of the unpleaded setoff defenses. It also allowed the denial of discovery by petitioner on the grounds that petitioner had three years to complete it, ignoring the fact that cutoff was ordered for October 20, 1987 and the Government did not raise the question of setoffs until November 1987. Equally, it ignored the affirmative representations of the Government that the book investments were not an issue because of the statute of limitations. The opinion of the Court of Appeals was filed on May 2, 1991, and a timely motion for rehearing was denied on September 20, 1991.

REASONS FOR GRANTING THE WRIT

This Court's decision in *United States v. Dalm*, 110 S.Ct. 1361 (1990) came down while this case was submitted before the District Court. Although it was drawn to the attention of the Court, there was insufficient time to analyze the case thoroughly. Unfortunately, we think the Court of Appeals was not sufficiently acclimatized to the opinion to recognize that it was a complete answer to the disposition of this litigation.

We believe that the Court was in error in the standards it utilized to adjudicate whether a "sham" transaction was involved, and that the failure to plead the setoffs resulting in lack of notice and prejudice to petitioner deprived him of a fair trial. In addition, allowing the Internal Revenue Service's unqualified censor to adjudicate what literary works should be allowed loss deductions seems to involve the burden on speech, which the Court found unconstitutional in *Simon & Schuster v. Members of the NY Crime Victims Board*, #90-1059 (decided 12/10/91). These items however need not be considered if the Court simply sends the matter back to the Court of Appeals for a redetermination in light of the *Dalm* decision.

1. **LEWIS VS. REYNOLDS, 284 U.S. 281 (1932) SHOULD BE OVERRULED, LIMITED, OR EXPLAINED**

In *Dalm*, *supra*, the Court reaffirmed the principles set forth in *Bull v. United States*, 295 U.S. 247, 262, *Rothen-sies v. Electric Storage Battery Co.*, 329, U.S. 296, and *Stone v. White*, 301 U.S. 532. In addition, *Dalm* clearly also approved the position we have urged from the start of this litigation that the mitigation statutes #1311 - 1314 of the Code should govern with respect to the statute of limitations problems. Both of these statutes and the doctrine of equitable recoupment require that setoffs barred by the statute of limitations can only be used defensively when the setoffs involve

the same transaction as advanced in the claim. In this case, the offsets are plainly not related to the net operating loss that was created in 1982.

Lewis v. Reynolds, supra, was not discussed in any of the Supreme Court cases cited in *Dalm*, and in the many cases in which it has been cited in the lower courts it appears to have been cited more for its colorful language in requiring that in order to collect a refund that taxes must be overpaid — basically a truism.

Unfortunately the language of *Lewis v. Reynolds* is extremely broad and seems to imply a substantive rule that in all refund cases the Government may offset unrelated items which for one reason or another it has failed to assert before the bar of the statute of limitations. It is this interpretation that was adopted by the Ninth Circuit. The cases which it cites do not support it since they refer to the “equitable” considerations which were defined narrowly in *Dalm* and which are not applicable, here.² It does cite, however, a popular tax handbook, Saltzman, *IRS Practice and Procedure*, ¶1102 at 11-6, 11-7 (1981). Additionally, it appears to be the conventional wisdom in the Department of Justice that the broad language of *Lewis v. Reynolds*, supra, allows the Government to utilize unrelated setoffs. Even though the Ninth Circuit opinion was certified “Not For Publication” the conventional wisdom of the Department of Justice and a few popular handbooks should be repudiated.

Lewis v. Reynolds may very well be an equitable recoupment case. It uses the term “equitable” and it is so interpreted in *First National Bank of Omaha v. United States*, 565 F.2d 507. Furthermore, the mitigation statutes were not passed until after *Lewis v. Reynolds*. Even that case does not pretend to grant a constitutional right to the Government to offset time-barred claims. *First National Bank* construes the

² *Trust Services of America v. U.S.*, 885 F2d 561, 9th Ct. (1989) expressly refused to decide whether unrelated transactions could be set off; See pg 566 and *Law v. U.S.*, 83-1 U.S.T.C. ¶13,514 (N.D. Cal.1982)

mitigation statutes as overruling *Lewis v. Reynolds*. The law review article cited in Dalm, 28 Arizona Law Review 595, interprets *Lewis v. Reynolds* so narrowly that it would have little or no application to this case.

The excellent recitation of legislative history of these statutes from pages 511 through 514 of *First National Bank of Omaha* clearly shows that the statutes incorporated what Congress considered an ordering and regulating of the instances of when either the Government or the taxpayer was entitled to relief from limitations. When a claim for refund is made, the Government should not be allowed to go on a fishing expedition. As the Court said in *Rothensies* at page 302: "Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup." The same policy considerations were expressed in *Ahmanson Foundation v. U.S.*, 674 F2d 761 9th Ct. (1981), *Union Pacific Railroad v. U.S.*, 524 F2d 1343, 1383 (Ct. Cl. 1975), and *Missouri Pacific Railroad v. U.S.*, 338 F2d 668, 672 (Ct. Cl. 1964).

Since it's clear that the Government is not entitled in this case to its setoffs under the District Court's equity powers as defined in this Court's cases unless there is somehow a common law of taxation (which we doubt) support for the Government must be found in the statutes. Chapter 66 of the Internal Revenue Code deals with limitations from Section 6501 through 6533. There is nothing in these statutes which in any way supports the opinion of the Court of Appeals or the position of the Government, which below argued for the broadest possible interpretation of *Lewis v. Reynolds*, *supra*.

If the regulations of the Internal Revenue Service are examined, commencing with Section 301.6501(c)-1, it will find no support for the Government's position below. The myriad of exceptions set forth simply do not support an interpretation of *Lewis v. Reynolds*, which allows the Government to offset time-barred claims except in the instances

we have previously mentioned, which do not apply to this case. The Ninth Circuit's claimed fixed rule simply does not exist. The decisions of the Supreme Court, the statute, the Congressional history, and the regulations, themselves, preclude the use of items barred by the statute of limitations to be used as a credit against claims of refund for different items. There are at least two cases in the Court of Appeals which support our position: *American Light and Traction Co. vs. Harrison*, 7th Ct., 142 F2d 639 154 A.L.R.1042, *Wood v. U.S.*, 2nd Ct. 213 F2d 660 (1954) *Ford v. U.S.*, Ct.Cl. 276 F2d 17 (1950) also supports our position.

2. THE COURT SHOULD NOT ALLOW THE CREATION OF A SPECIAL LIMITATION PERIOD FOR NET OPERATING LOSS CARRYBACKS

A rule which allows the Government to utilize unrelated items as offsets might be desirable, however it's beyond the power of the Court of Appeals to create such a rule. There is no common law of taxation and this Court's rulings with respect to equitable recoupment precludes the use of the equity power of the Court. In *Comm. v. Gooch M&E Coe*, 320 U.S. 419, 64 S.Ct. 184, the Government denied a similar attempt by the Government to create a general rule in the Tax Court which would allow the offset of the same items in different years. Taxes are a creature of statute, and Congress' idea of policy must prevail.

An examination of the Congressional history of the net operating loss provisions of the Code makes it abundantly clear that Congress intended to grant relief to businesses who perhaps because of economic conditions beyond their control had unprofitable years. This Court so found in *U.S. v. Foster Lumber Co.*, 429 U.S. 32 97 S.Ct. 204-211. The sections were intended as relief provisions. *Penton v. U.S.*, C.A. Tn. 295 F2d 536 (1958).

It would appear to be contrary to Congressional policy to allow in these cases a fishing expedition into the taxpayer's entire return for the year in which the refund was claimed. Furthermore, the specific statutes and regulations dealing with net operating losses not only do not support the Ninth Circuit ruling, they are directly to the contrary. Section 6511(d)(2)(4) governs the statute of limitations in the case of carrybacks. There is nothing in this section which allows unrelated offsets. In the regulations which specifically have to do with limitations in net operating cases, the Ninth Circuit rule is nowhere to be found; see Section 301.6511(d)-2.

Furthermore, although they are not a model of clarity, the Treasury regulations with respect to the mitigation statutes make clear that they apply to net operating loss carrybacks. In regulation 1.1314(c)-1 entitled "Adjustment Unaffected by Other Items" provides:

"(a) The amount of any adjustment ascertained under §1.1314(a)-1 or §1.1314(a)-2 shall not be diminished by any credit or set-off based upon any item other than the one that was the subject of the adjustment."

Regulation 1.1314(a)-2 specifically refers to net operating loss deductions as follows:

"(2) The net operating loss deduction or capital loss carryback or carryover must be determined with reference to the taxable year with respect to which the error was made."

The Ninth Circuit opinion also overlooks the facts in this case. As we indicated in our statement of the case and illustrated by the graph, refunds were only claimed for 1978 and 1980, years in which the offsets were applicable. Refunds then should have been allowed even under the Ninth Circuit rules for the other years involved. Under the special rule of the mitigation statutes, we are always concerned with carrybacks, and the statutes are clear that refunds in those cases

are not to be affected by other items in the tax returns. This is equally clear when the shoe is on the Government's foot. Reference also should be made to this Court's decision in *McEachern, Adm. v. Rose*, (1937) 302 U.S. 56, 58 S.Ct. 84, 85.

3. THE RULES OF PLEADING WHILE LIBERALIZED HAVE NOT BEEN ABOLISHED, PARTICULARLY WHERE THERE IS PREJUDICE

Modern notice pleading allows great latitude in the construction of pleadings and the amendment of pleadings, however the rules of pleadings have not been abolished, even for the Government. The setoffs claimed, here, should have been the subject of a counter claim under Rule 13, however at the time of trial there was no pleading, formal or informal, which set forth these defenses; in fact, somewhat surprisingly the Government even dismissed the only counter claim it had filed (even this counter claim had not been served). In *Conley v. Gibson*, 355 U.S. 41, this Court indicated that "the Federal rules reject the approach that pleading is a game of skill." However, the rules do not contemplate the abolishment of pleadings to the prejudice of a litigant. See *Armstrong Cork Co. v. Lyons*, 366 F.2d 206 (1966). Here, the dismissal of the 1980 counter claim was but the last of a series of skillful moves by Government counsel to utilize the District Court's discovery cut-off order to deny the documentation and testimony of the New York witness. From January 1985 to at least October 1987, the Government affirmatively represented to petitioner that the book investments were not an issue in the case because of the statute of limitations. By Government counsel's clever manipulation of stipulated extension and by refusing to agree to the authenticity of documents which it had filed under its own affidavit in a summary judgment motion, petitioner was deprived of any opportunity to disprove the Government's assertion that the book investments were a "sham."

Under Rule 13(f), the counter claims could have been pled at almost any time. Under Rule 15 of the Rules of Civil Procedure amendments are favored, but Rule 15(b) also provides for "a continuance to enable the objecting party to meet such evidence."

The District Court treated its discovery cutoff order as if it was built in stone. Cutoff was in October 1987 and the trial did not take place until April 1989. On three occasions, petitioner attempted to reopen discovery to get the documentation, the lack of which the District Court relied upon to deny petitioner's claim for refund. The petitioner, in brief, has been substantially prejudiced. In *International Harvester Credit v. East Coast Truck*, 547 F2d 888, a District Court was reversed for allowing under pleading defenses where the plaintiff was not allowed an opportunity to defend. See also *McGlinchy v. Shell Chemical Co.*, 445 F2d 802 9th Ct. (1988).

In this case, until the District Court after a lengthy submission decided the question of the statute of limitations, the book issues were simply not in the case, nor were they in the case before that time because of the Government's affirmative representation that the statute barred the issue. In addition the Court should not have denied petitioner the right to use a librarian witness who, by the use of modern library materials, could have demonstrated that the books were not a "sham" but had substantial economic merit in the literary marketplace. The refusal to reopen discovery, plus the refusal to allow the documents filed with the Government's affidavits in the summary judgment motion, plus the refusal to admit these documents (even when it was established they they were relied upon by the only substantial Government witness), deprived petitioner the fair trial guaranteed by the Constitution.

4. THE USE OF INTERNAL REVENUE SERVICE EXPERTS TO CENSOR LITERARY WORKS AND POSSIBLY IMPOSE RELIGIOUS STANDARDS IN ADMINISTERING THE LAW STANDARDS OF SECTION 183 SHOULD BE DISAPPROVED

In this case, the District Judge's only reliance, affirmatively, was on the testimony of the so-called expert. She was one of a team of experts which for a number of years the Government had been using to evaluate literary projects with the view to allowing or disallowing losses. The annotations under Section 183 are replete with references to the testimony of these so-called experts. One example is the companion case of Harris Cashman, #91-834. Other cases related to this one are: *Elliott v. Comm.*, 84 TC227; *Ziegler v. Comm.*, TC Memo 1984-620; and *Leger v. Comm.*, TC Memo 1987-146. At least one Tax Court case has suggested that appraisal testimony in these kinds of cases is inappropriate; see *Abramson v. Comm.*, 86 TC 360. Books are, after all, speculative investments and Monday morning quarterbacking after it is known that there were losses is not much help.

This case is a perfect example of the Tax Court Judge's misgivings. The witness' principal employer for the last five years had been the Internal Revenue Service for fees ranging from \$60,000 to \$150,000 a year. She exhibited a strong bias in favor of the Government, even expressing this in personal terms to petitioner's counsel. Her background was principally in the publishing of Protestant Sunday School products. How far her religious orientation affected her judgment of the merits of Mr. Moore's book was not clear, but such a background would not appear to be consistent with a favorable report on paperback romance novels. In judging the market for country western music videos, the witness' experience was limited to the production of a videotape for

Sunday Schools entitled "Six New Testament Walks in Jerusalem." Her ability to judge the market for bar entertainment, television and home use would seem to be non-existent, yet based on her testimony the District Court found that this investment was a "sham."

The problem of these experts judging literary merit in the field of taxation raises a serious problem with respect to the First Amendment and the establishment clause. This Court several days ago came down with the *Simon & Schuster* case, *supra*, which dealt with State regulation of literary financing. We would estimate that criminals making money with books about their crimes are relatively few in number as compared with the great number of authors in the literary marketplace. By the Internal Revenue Service's campaign under Section 183 to limit loss deductions, they are taking the power in a most complete sense, economically, to judge the text and even the political information that will be given to the public. In this case, we had romance novels which may or may not be trash, as this witness found, but also we have political party history by Arthur Schlesinger, and oddly enough another criminal in E. Howard Hunt. We urged to the Court of Appeals, and we urge to this Court that the witness was simply unqualified. In the larger context, however, this Court should consider the impact of sectarian review in both the entertainment and political field.

The District Judge's decision was based almost entirely on the opinion evidence of the so-called expert. She was practically a full-time employee of the Internal Revenue Service. Her opinion was based upon the content of the books involved in the litigation, and the nature of the entertainment in the case of the country videotape. Denying a business deduction on the basis of such opinions is the kind of financial restraint disapproved by this Court in *Simon & Schuster*, *supra*.

5. THE COURT SHOULD REVIEW THE STANDARDS FOR DISALLOWING BUSINESS LOSSES, INCLUDING APPELLATE REVIEW

This case and its companion, *Harris Cashman v. Comm.*, #91-834, are literally identical twin cases, both in a biological sense and with respect to some of the business losses disallowed. Both cases involved the investment in literary properties which on one hand the Tax Court found were "bona fide" and on the other hand, the District Court found were a "sham." In spite of this varying treatment, both courts disallowed these business losses for tax purposes. Particularly in the literary and entertainment fields, the Internal Revenue Service is imposing its views, whatever they may be, by deciding which losses are business and which losses are non-business and which do not qualify as tax deductions. The inherent dangers in this non-accountable supervision are obvious. In the companion case, we discussed the Section 183 approach which was adopted in the case. Here, we have the "sham" transaction which is governed by this Court's case of *Frank Lyon Co. v. U.S.*, 98 S.Ct. 1291 (1978). As we pointed out in *Harris Cashman*, the Court should decide whether the standards for these two basis of disallowance are the same. Furthermore, the Court should decide whether the two-part test found in *Lyon*, *supra*, by the Courts of Appeal require both elements or one since the Courts of Appeal are not in agreement; see *Shriver v. Comm.*, 899 F2d, 724, 8th Cir. (1990); *Freidman v. Comm.*, 86 F.2d 785 at 792, 4th Ct. (1989); *Kirshman v. Comm.*, 862 F2d 851, 6th Ct. (1989); *Rice's Toyota World v. Comm.*, 752 F2d 89 (1985).

In *Rice's Toyota World* and *Shriver*, the text was defined as follows:

"That is, a transaction is a sham if (1) it is not motivated by any economic purpose outside of tax considerations, and (2) is without economic substance because no real potential for profit exists."

On the facts, neither Cashman case would seem to qualify de facto. In the Harris Cashman case since the Tax Court found the transaction was "bona fide" it did not seem to qualify de jure.

In this case, with respect to the country music videotape investment, not only cash but a recourse note was involved, which under the tax law is a cash equivalent. In *Frank Lyon*, supra, the Court's main reliance was on the fact that *Lyon* exposed its business well being to a "real and substantial risk." At 576. Both Cashman cases are of course in conflict with Rice's *Toyota World* since they disallowed the cash.

In *Comm. v. Groetzinger*, 107 S.Ct. 980 (1987), this Court indicated that in determining what was a legitimate trade or business, the Appellate Courts must examine the facts in each case. At 987. We find it hard to believe the Court was that concerned with the regulation of bookies. It seems probable that it desired to apply this standard, generally.

The Court, here, treated the District Court's decision that the investments were "shams" as a matter of fact. In *Lyon*, supra, this Court approved the decision in *American Realty Trust v. U.S.*, 498 F2d 1194, 1198 (CA 4 1974), that whether a transaction was a "sham" was a question of law. At 580. In this case there was very little dispute of the facts, and under *Frank Lyon*, the fact that Cashman may have considered tax considerations is irrelevant. The Appellate Courts below should by means of this case be advised to examine the facts of a transaction before disallowing business losses on the grounds that the business was not legitimate. Any other decision because of the Commissioner's presumption of correctness would invite a rubber stamping by the Tax and District Courts, and a further rubber stamping by the Court of Appeals.

This case is an even better case for review since it points up the problems of the burden of proof where the Government belatedly by means of a fishing expedition dredges up previously unconceded items of a litigant's tax history to defeat a legitimate claim for refund.

Further, it illustrates the enormous problem of proving a negative; see *Cohen v. Comm.*, 9th Ct., 266 F2d 5. Here, the Government did little more than charge (and that without a pleading) that the taxpayer's investments were a "sham." Overcoming this charge by proving that it was clearly erroneous is close to being impossible.

CONCLUSION

It is to be hoped that the Solicitor General will not waive his right to reply to this petition. In view of the shifting perception of the Department of Justice as to whether unrelated setoffs barred by the statute of limitations can be used as a defense, the Government should state its position for the record.

We also suggest that this Court, in the interest of orderly tax administration, advise the Tax Bar whether the narrow interpretation of time-barred claims of *United States v. Dalm*, supra, applies to taxpayers, alone, or to the Government as well.

Respectfully submitted,

RICHARD H. FOSTER

RICHARD H. FOSTER
Attorney for Petitioner

APPENDICES

**APPENDIX A: ORDER DENYING MOTIONS FOR
SUMMARY JUDGMENT**

**APPENDIX B: FINDINGS OF FACT AND
CONCLUSIONS OF LAW**

APPENDIX C: ORDER

**APPENDIX D: MEMORANDUM OPINION OF THE
COURT OF APPEALS**

**APPENDIX E: ORDER DENYING PETITION FOR
REHEARING**

APPENDIX F: STATUTES INVOLVED

IRC § 1311

IRC § 1314

FRCP RULE 15(b)

APPENDIX A

United States District Court

DISTRICT OF NEVADA

MORGAN CASHMAN,

Plaintiff,

vs.

UNITED STATES
OF AMERICA,

Defendant.

CV-LV-85-28-LDG

**ORDER DENYING MOTIONS FOR SUMMARY
JUDGMENT**

Plaintiff initiated this action seeking a refund of federal income taxes for his 1978 and 1980 tax years, plus interest. Plaintiff challenged the denial by the Internal Revenue Service of three purported investments by plaintiff which resulted in alleged losses and investment tax credits. On November 23, 1987, defendant filed its motion for summary judgment, alleging that the investments were not entered into with a bona fide expectation of profit and thus did not qualify for depreciation or investment tax credit. Defendant's motion is supported by requests for admissions which it argues should be deemed admitted for plaintiff's failure to timely respond. Plaintiff argues that the responses to requests for admissions were only two or three days late, and that defendants have demonstrated no prejudice for the lack of timeliness. Plaintiff further alleges that defendant agreed to extend the time for a response. The court concludes that the requests for admissions should not be deemed admitted, and defendant's motion for summary judgment will be denied.

On December 29, 1987, plaintiff filed a cross motion for summary judgment apparently arguing that the statute of limitations bars defendant from inquiring into the tax years 1976, 1977, 1978 and 1979, and thus have no defense to the

refund. Defendant argues that the fact that the statute of limitations has expired and the IRS is barred from the assessment and collection of additional tax does not affect defendants right to assert a setoff in order to prove the absence of an overpayment. Moreover, defendant argues that the IRS made assessments with respect to the years 1978 and 1979. In response, plaintiff alleges that defendant is mistaken in its assertion that assessments were made. As an issue of fact remains with respect to this question, summary judgment is not proper. Accordingly,

IT IS HEREBY ORDERED that defendant's motion for summary judgment (#27) and plaintiff's cross motion for summary judgment (#29) are denied.

Dated 16 July 1988.

LLOYD D. GEORGE
United States District Judge

APPENDIX B

United States District Court

DISTRICT OF NEVADA

* * *

MORGAN CASHMAN,

Plaintiff,

vs.

UNITED STATES OF
AMERICA,

Defendant.

CV-S-85-028-PMP

**FINDINGS OF FACT
AND CONCLUSIONS
OF LAW**

This action was commenced on January 16, 1985, by the filing of Plaintiff's Complaint for Refund of Taxes paid by Plaintiff for the years 1976 through 1981.

Plaintiff alleges that a net operating loss of \$164,624.00 incurred in 1982, entitles him to net operating loss carrybacks for the years 1979, 1980 and 1981, and to credits for unused investment tax credits reducing his taxable income for the years 1976, 1977 and 1978, resulting in an entitlement to a refund for those years.

On December 6, 1984, the Internal Revenue Service ("IRS") denied Plaintiff's claim for refund except for the year 1979 in which the IRS granted a refund in the principal amount of \$10,033.00. The refund denials involved a determination by the IRS that losses claimed on Plaintiff's Schedule C for the years 1978 and 1979 in connection with Plaintiff's investment in the publishing of a book called "The Triumph;" a claimed partnership loss for the year 1979 in a limited partnership named "Dover Publishing;" and a claimed loss in investment credits in a country music videotape investment on Plaintiff's Schedule C for the year 1980, should be disallowed. Plaintiff alleges that disallowance of these losses by the IRS was "arbitrary, unreasonable and

contrary to law” and that Plaintiff is entitled to refund of \$82,469.00 in principal plus interest by virtue of his Complaint. More particularly, Plaintiff contends that he is entitled to recover taxes in the amounts of \$11,065.00 for 1976, \$10,739.00 for 1977, \$4,368.00 for 1978, \$45,187.00 for 1980 and \$11,110.00 for 1981.

This Court has jurisdiction over the matter pursuant to Title 28, United States Code, Sections 1340 and 1346(a)(1) and Title 26, United States Code, Section 7422.

Reassignment of this case to the undersigned occurred on May 3, 1989, and on May 9, 1989, trial commenced before the Court sitting without a jury. Trial continued on May 10 and 11, 1989, and was thereafter continued to June 29, 1989, at which time the trial was completed. Post-trial briefs were filed by Plaintiff on August 9, 1989 (#103), by Defendant on September 8, 1989 (#107) and by Plaintiff on September 18, 1989 (#108). On October 13, 1989 and April 10, 1990, Defendant and Plaintiff respectively filed Notices of Pertinent Decisions (#111 and #115). On April 20, 1990, Defendant filed a Response to Plaintiff's Supplemental Memorandum of April 10, 1990, and on that date the Court heard final oral argument regarding this case.

At the close of Plaintiff's case-in-chief at trial, Defendant moved for dismissal of Plaintiff's action pursuant to Rule 41(b) of the Federal Rules of Civil Procedure. The Court at this time denies Defendant's 41(b) Motion. However, for the reasons set forth below, the Court concludes that Judgment must be entered in favor of Defendant and against Plaintiff.

I.

In a tax refund action, the taxpayer bears the burden of proving the exact amount the taxpayer is entitled to recover.

As a general matter, the taxpayer also has the burden with respect to all issues bearing upon the recovery amount, including issues raised when the Government

asserts as a defense, in the nature of a setoff, the impropriety of some deduction previously allowed with respect to the same return.

Ahmanson Foundation v. United States, 674 F.2d 761, 776-777 (9th Cir. 1981). Of course, the Government bears some burden of establishing that its equitable setoff defenses to a tax refund suit are made in good faith and are not completely lacking in substance. *Id* at 777.

Considering all the evidence adduced at the trial of this matter, the Court finds Plaintiff has failed to demonstrate by a preponderance of the evidence that he overpaid his taxes for 1976, 1977, 1978, 1980 and 1981. The Court finds that Defendant properly disallowed the losses claimed by Plaintiff in connection with his investments in the publishing and videotape ventures.

A. *"The Triumph" and the "Dover Collection"*

During the years in question, Plaintiff owned, with his twin brother Harris Cashman, a business called Cashman Photo, that produced and sold to patrons of various Las Vegas casinos, photographs of those patrons taken by "photogirls" employed by the business. Plaintiff testified that the business employed approximately 250 people and that Plaintiff was paid approximately \$150,000.00 to \$200,000.00 per year during the years at issue.

Plaintiff testified that in 1978, he invested in a venture involving a book called "The Triumph" by Arthur Moore. Plaintiff further testified that in 1979 he invested in a limited partnership involving a number of books called the "Dover Collection." Plaintiff testified that the two investments were made at the recommendation of his accountant, George Swarts, and that Plaintiff thought they were "good" investments that "would make money." Plaintiff testified that although he recalled his accountant, Mr. Swarts, mentioning that there were tax benefits to the investment, Plaintiff claims

that tax benefits or savings paid no role in his decision to invest in the two book ventures. The Court finds Plaintiff's testimony in this respect to be incredible.

Plaintiff has utterly failed to provide documentary substantiation, beyond his own testimony, to establish that he is entitled to refund based upon the investments in the two book ventures. *Liddy v. Commissioner*, 808 F.2d 312, 315-316 (4th Cir. 1986), *reh'g denied*, 815 F.2d 1007, (4th Cir. 1987). Plaintiff failed to produce even a photocopy of the contracts and notes underlying the book venture investments. Plaintiff has also failed to produce cancelled checks which would evidence how much he invested in the respective book ventures.

To obtain deductions for depreciation and business expenses under Sections 167 and 162 of the Internal Revenue Code, Plaintiff must demonstrate a bonafide profit motive that was dominant. *Independent Electric Supply, Inc. v. Commissioner*, 781 F.2d 724, 728 (9th Cir. 1986). To obtain any tax benefits, the transaction giving rise to the benefit must not be a sham lacking in economic substance. *Knetsch v. United States*, 364 U.S. 361, 366-367 (1960). The evidence adduced at trial demonstrates conclusively that Plaintiff lacked the requisite profit motive to justify deductions for the two book ventures.

Plaintiff and his accountant, George Swarts, testified that neither had any experience in publishing and that there was no pre-investment investigation regarding the two book ventures. Neither was there any meaningful post-investment effort to monitor, promote or safeguard the investments made in the two book ventures.

Although Plaintiff did not call his former accountant, Mr. Swarts, to testify, Defendant did. Mr. Swarts testified that there were no outside appraisals concerning the book venture; that his investigation into the book ventures did not go beyond reading the prospectus prepared by the promoters and a telephone conversation with the promoters' agent; that he had no idea as to the basis of the property purchased in the

transaction; that he was unable to say how much money was invested in either book venture; and that he had no expertise in publishing. Mr. Swarts further testified that it was his recollection that he recommended the book venture investments to Plaintiff after Plaintiff had asked him to help find "tax-sheltered investments."

Finally, the uncontroverted expert testimony offered by Defendant clearly established that even if Plaintiff made the investments he claimed to have made to the two book ventures, their fair market value was zero.

Plaintiff has utterly failed to meet his burden of proof with regard to entitlement to deductions for the book venture investments. Indeed the record demonstrates Plaintiff's claimed investments were shams lacking in economic substance which do not entitle Plaintiff to any deductions or credits.

B. The Videotape Venture

The record adduced at trial with respect to the videotape venture investment is much the same as that with regard to the two book venture investments. The videotape investment contemplated the production and distribution of videotapes of songs by country-western performers, Jimmy Newman and Norvell Phelps, which would be distributed for play in bars and lounges in much the same fashion as tapes or records are played in a juke box.

Plaintiff testified that he entered this venture in December 1980 on the advice of another accountant, Larry Swecker. Plaintiff testified that the investment involved a master tape of five songs to be performed either by Jimmy Newman or Norvell Phelps for which Plaintiff testified he was to pay \$20,000.00 for each taped performance of a song (called a unit), for a total of \$100,000.00. Of that \$100,000.00 investment, Plaintiff testified that he paid \$25,000.00 on December 2, 1980, as evidenced by a receipt, with the \$75,000.00 balance subject to a note dated December 3, 1980. Exhibits 25 and 25A.

Plaintiff testified that he became aware of the video venture investment through Mr. Swecker, and that he relied entirely on Mr. Swecker to evaluate the investment. However, Plaintiff acknowledged that Mr. Swecker never gave him any idea as to when the investment would produce revenue and that neither he nor Mr. Swecker attempted to make any income projections regarding the proposed investment nor did they review any projected income statements.

Mr. Swecker testified that although "tax benefits" were mentioned in his discussions with Plaintiff regarding the video venture investment, and although the investment would save Plaintiff \$43,000.00 in taxes in 1980, Plaintiff had not expressed an interest in participating in a venture which Mr. Swecker would characterize as a "tax shelter." However, Mr. Swecker testified that Plaintiff did bring him for review, tax shelter packages that Mr. Swecker thought were too risky and which had too much potential for trouble with the IRS.

At the time Plaintiff claims to have made his investment, the videotape "units" had not yet been produced. Indeed, it appears that there was no agreement with either Mr. Newman or Mr. Phelps to produce the videotape units at that time. Neither Plaintiff nor his accountant had any background or expertise in country-western entertainment or in videotape production or distribution. Further, Plaintiff testified that he made no efforts to monitor the progress of his investment or to promote it. Plaintiff testified he has never seen the videotapes purportedly produced and does not know where they are kept. Plaintiff never took steps to insure the tapes, to appraise the tapes or to make duplicate of the tapes to protect them in the event the originals are destroyed or lost. Plaintiff further testified that he has not paid the \$75,000.00 balance due on the investment note nor has demand for payment been made.

Finally, the uncontroverted expert testimony presented by Defendant demonstrates that the fair market value of the video venture investment in December 1980 was zero.

As with the two book venture investments discussed above, the Court finds that Plaintiff's investment in the videotape venture was not made with a bonafide profit motive that was dominant. *Independent Electric Supply, Inc.*, 781 F.2d 724, and *Flowers v. Commissioner*, 80 T.C. 914, 931 n.24 (1983). Therefore, Plaintiff is not entitled to deductions for depreciation under Section 167 of the Internal Revenue Code, for business expense under Section 162 of the Internal Revenue Code, or for investment tax credits under Sections 38 and 48 of the Internal Revenue Code.

II.

Throughout these proceedings, Plaintiff has advanced a somewhat confusing argument to the effect that because Defendant failed to make a timely deficiency assessment for 1978 for the amount of \$49,700.00, and that because the statute of limitations for doing so has expired, Plaintiff is somehow relieved from proving that the tax deductions and credits relating to Plaintiff's two book venture investments were proper and that Defendant may not challenge them in defending against Plaintiff's suit for refund. Plaintiff's argument in this regard was rejected by the Court on summary judgment and on motion for reconsideration of the Court's ruling regarding summary judgment. Nonetheless, Plaintiff has persisted in raising the issue during trial and post-trial, most recently in the form of a supplemental memorandum filed April 10, 1990 (#115). The Court once again must reject Plaintiff's argument that the statute of limitations in some way bars Defendant's right to challenge the deductions and tax credits flowing from any of the investment ventures at issue in this case.

As stated previously, in a tax refund suit the Plaintiff bears the burden of proving the exact amount he is entitled to recover. *Ahmanson*, 674 F.2d 761. Simply because the statute of limitations has expired for the IRS to assert a deficiency assessment for any particular year in question, does not bar the Defendant from asserting as a defense, in the nature

of a setoff, the impropriety of some deduction previously allowed with respect to the return for which Plaintiff seeks a refund. *Id.* at 761.

As neither party in this case is seeking relief from a limitations statute, the mitigation statutes, Sections 1311 through 1314 of the Internal Revenue Code of 1986, have no application. Neither is the doctrine of equitable recoupment, recently addressed by the United States Supreme Court in *United States v. Dalm*, No. 88-1951, 90 C.D.O.S. 1947 (March 20, 1990), a copy of which is attached to Plaintiff's Supplemental Memorandum (#115) filed April 10, 1990, implicated in this case.

Simply put, the fact that Defendant failed to make a timely deficiency assessment of \$49,700.00 for the year 1978, does not relieve Plaintiff of the obligation of proving that the deductions and credits related to the investments in the book and videotape ventures were valid. Plaintiff has completely failed to meet his burden in this regard, the Defendant accordingly is entitled to Judgment.

Based upon the foregoing Findings of Fact and Conclusions of Law, the Court hereby enters Judgment on behalf of Defendant United States of America and against Plaintiff Morgan Cashman, each side to bear their own costs and attorneys fees.

IT IS ORDERED that the Clerk of Court shall forthwith enter Judgment accordingly.

DATED: April 23, 1990.

PHILIP M. PRO
United States District Judge

APPENDIX C

[Filed August 16, 1990]

United States Court of Appeals

For The Ninth Circuit

* HARRIS CASHMAN, *et al.*,

Plaintiffs-Appellants,

vs.

COMMISSIONER
INTERNAL REVENUE
SERVICE, *et al.*,

Defendants-Appellees.)

Nos. 89-70532
90-15806

DC# CV-85-0028-PMP
Nevada (Las Vegas)

ORDER

On August 14, 1990, a prebriefing conference was held before Conference Attorney Meg Gerrity. Appellants Harris Cashman and Morgan Cashman were represented by Richard H. Foster. Appellees Commissioner and United States of America were represented by Stephen W. Parks.

No. 89-70532 is stayed pending completion of briefing in No. 90-15806. The clerk shall calendar these appeals for decision by the same merits panel. The Time Schedule Order of June 13, 1990 in No. 90-15806 shall remain in effect. Fed. R. App. P. 28(g) shall govern the length of briefs. However, counsel should avoid repetition of material set forth in the briefs filed in No. 89-70532, and should incorporate by reference material from those briefs where practicable.

8.14.90/1 * Although only Harris Cashman is mentioned, this Order covers both Harris and Morgan Cashman which had separate docket numbers in the Court of Appeals. The docket number for Harris Cashman in this case is 91-834. _

2c

This order is subject to reconsideration by a judge if any objection is filed within 10 days of the entry of the order.

FOR THE COURT:

Meg Gerrity
Conference Attorney

APPENDIX D

[Filed May 2, 1991]

NOT FOR PUBLICATION

United States Court of Appeals

FOR THE NINTH CIRCUIT

MORGAN CASHMAN,

Plaintiff-Appellant,

v.

UNITED STATES
OF AMERICA,

Defendant-Appellee.

No. 90-15806

D.C. No.

CV-85-0028-PMP

MEMORANDUM*

Appeal From the United States District Court
For the District of Nevada
Philip M. Pro, District Judge, Presiding

Argued and Submitted, March 14, 1991
Stanford Univ., Palo Alto, Calif.

BEFORE: D.W. NELSON, KOZINSKI, AND T.G. NELSON, CIR-
CUIT JUDGES

Morgan Cashman appeals the district court's affirmance of the Commissioner of the Internal Revenue Service's ("Commissioner" or "IRS") denial of a tax refund for 1976, 1977, 1978, 1980, and 1981. He argues that carrying back net operating losses from 1982 to 1979 and 1980 should allow him to free investment tax credits and deductions in those latter years for carrying back to 1976-78 and forward to 1981,

* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

thus earning refunds for those last years. The government retorts that it need not permit those deductions and credits because they were for sham investments. Appellant counters that reconsideration of those deductions is time-barred and that they were legitimate anyway. We affirm the district court because neither does the statute of limitations apply, nor were the investments entered into for a business purpose or likely to produce economic benefits.

I. STATUTE OF LIMITATIONS

A. The Principle of Lewis

Whether the IRS was found by the statute of limitations in reexamining past tax years to offset claimed refunds is a legal question that the panel reviews de novo. *Cf. Trust Services of America, Inc. v. United States*, 885 F.2d 561 (9th Cir. 1989) (review de novo holding that government foreclosed by estate tax closing letter from claiming setoff defenses in refund action).¹

The statute of limitations requires that “the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed...” 26 U.S.C. §6501(a). Appellant argues that this means that after this time period the IRS may not reexamine a taxpayer’s filings to discover additional liabilities with which to offset potential refunds. While not disputing its inability to assess new deficiencies for those years, the government argues that it may use erroneously unassessed liabilities in those returns to offset claimed refunds. It believes that this case falls squarely within the ambit of *Lewis v. Reynolds*, 284 U.S. 281, *modified*, 284 U.S. 599 (1932), while appellant protests that *Lewis* has been implicitly overruled both by subsequent cases and by revisions of the Internal Revenue Code.

¹ Appellant’s brief does not bother to include standards of review, a requirement he obviously sees as being as superfluous as the inclusion of dates and circuits in citations to the Federal Reporter.

In *Lewis* trustees of an estate sued the IRS for failure to grant a refund. The petitioners asked that the IRS refund to them money paid on the basis of the IRS' incorrect refusal to allow a deduction for state inheritance taxes. While admitting this error, the Commissioner stated that another deduction for attorney's fees had been improperly allowed. Offsetting the refund with this greater amount, the Commissioner determined that no refund was owed. Petitioners claimed that the Commissioner could not redetermine and reassess the tax as an offset after the statute had run. The Supreme Court disagreed.

It first quoted with approval from the Court of Appeals decision below:

"[T]he ultimate question presented for decision, upon a claim for refund, is whether the taxpayer has overpaid his tax. This involves a redetermination of the entire tax liability. While no new assessment can be made, after the bar of the statute has fallen, the taxpayer, nevertheless, is not entitled to a refund unless he has overpaid his tax...it is incumbent upon the claimant to show that the United States has money which belongs to him."

Id. at 283 (quoting *id.*, 48 F.2d 515, 516 (10th Cir. 1931)). The Court then concluded:

While the statutes authorizing refunds do not specifically empower the Commissioner to reaudit a return whenever repayment is claimed, authority therefor is necessarily implied. An overpayment must appear before refund is authorized. Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Id. This is quite a difficult obstacle for appellant to overcome.

Lewis, despite appellant's protestations to the contrary, has become a fixture of tax law. For example, in *Trust Services of America, Inc. v. United States*, 885 F.2d 561 (9th Cir. 1989), we looked at whether sending an estate tax closing letter foreclosed the government from claiming setoff defenses in a refund action. The court first quoted the tax court: "Although the government has the right to re-audit a return and raise any tax deficiency as a setoff to any refund due, *see Lewis*...the government is estopped [here because of the letter]." *Id.* at 565 (quoting *Law v. United States*, 83-1 U.S.T.C. ¶13,514 (N.D. Cal. 1982)). *Trust Services* went on to reverse the district court in part, holding that even the letter did not bar the government from asserting one of its setoff claims. Commentators, too, have found the *Lewis* principle to be well established. *See, e.g.,* Saltzman, *IRS Practice and Procedure* ¶11.02 at 11-6, 11-7 (1981); 4 Bittker, *Federal Taxation of Income, Estates and Gifts* ¶115.7 at 115-40, 115-41 (1981).

B. *Lewis* Overruled?

Cashman argues that other Supreme Court cases have overruled *Lewis* *sub silentio*. He relies on the recent case of *United States v. Dalm*, 110 S. Ct. 1361 (1990), for the "unspoken premise" that a setoff is insufficient to avoid the statute of limitations bar. "Unspoken" is a great exaggeration; unconsidered would be a more appropriate adjective. *Dalm* ruled that the doctrine of equitable recoupment did not allow the *taxpayer* to institute a suit for refund of an earlier paid

gift tax after the taxpayer had agreed to pay tax on the transaction. Equitable recoupment, which permits the taxpayer to offset tax paid on an erroneous theory against tax properly asserted and due, has no bearing on this case.²

Appellant also draws our attention to *Rothensies v. Electric Battery Co.*, 329 U.S. 296 (1946), where the Court held that the taxpayer could not, in this proceeding against 1935 tax liability, recoup a refund of excise taxes improperly paid in 1919-22, as such were barred by the statute of limitations. Once again, the relevance to the present case is slight. Cashman argues that the key is *Rothensies*' emphasis on the idea that the statute of limitations bars claims arising from different transactions or taxable events. He analogizes to his case by saying that the 1982 net operating loss is a different transaction from the investment tax credits and deductions in 1978-80. For additional support, he cites to *McEachern v. Rose*, 302 U.S. 56 (1937), for the principle that an offset may not be claimed for a year other than the year in which a refund is claimed. As a result, the government is barred from raising the supposed invalidity of those credits and deductions in this action.

This argument is not convincing. First of all, the government does not contest either the net operating losses from 1982 or appellant's ability to carry them back. The taxpayer, however, seeks refunds for the years 1976-78 and 1980-81. The potential for those refunds arises only because he believes he may now carry elsewhere the credits and deductions in 1979-80 that he no longer needs. Yet, to determine whether he may carry these back and forward to reduce tax liability in the five claimed years, the government must accept their validity. It may reexamine those investments to assess whether the deductions and credits are actually due. The whole underlying point of *Lewis* is that the government may

² Equitable recoupment is not limited to the taxpayer, but may also be claimed by the government. See *Dalm* at 1368. In any event, both parties' briefs agree that it is not involved here.

“retain payments already received when they do not exceed the amount which might have been properly assessed and demanded,” *id.* at 283, that this process “involves a redetermination of the entire tax liability.” *Id.* Here, the taxpayer’s action led the IRS into a reexamination of the credits and deductions he wishes to carry. Isolated years are not involved here; rather, the government’s holistic view is preferable.

In a related issue, appellant claims that the government cannot prevail because it did not timely plead its proposed setoffs and counterclaims. This misapprehends what this case concerns. The case does not revolve around the validity of the 1982 net operating losses, with the setoffs being a possible counterclaim. Instead, this case concerns whether taxpayer may obtain a refund for the five claimed years. The government correctly explains that he should not because his credits and deductions should be disallowed. There is no counterclaim to be pleaded.

C. Mitigation Statutes

Cashman offers another implicit overruling of *Lewis* in the guise of Code sections 1311-14, which are mitigation provisions introduced in 1954. He quotes from §1314, entitled “Adjustment unaffected by other items,” which says, in part:

The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this part, shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment.

26 U.S.C. § 1314(c). Read alone, this may be alluring; read properly in context, it is irrelevant. § 1311(b), entitled “Conditions necessary for adjustment,” makes clear that a § 1314 adjustment occurs only when the position of the taxpayer or

the IRS is inconsistent as to different tax years. In other words, if either party attempted to treat the same item differently in two different tax years, an adjustment would not be diminished or enhanced by a setoff. In this case, the IRS is treating the 1978-80 deductions and credits *similarly*. Cashman perceives the inconsistency to occur between its treatment of those investments before his claim for a refund and after. That is not the inconsistency to which this section refers. It only covers inconsistent treatment of the same action in *different years*. His argument under this section must fail.

In sum, appellant's position is based too largely on flimsy parallels and supposed inferences to defeat long-understood premises. We uphold the district court's ruling that the statute of limitations does not act as a bar.

II. BURDEN OF PROOF

Whether the district court properly imposed the burden of proof is a question of law reviewed de novo. *See United States v. Janis*, 428 U.S. 433, 440-43 (1976) (implies this is an issue of law).

Cashman argues that the government bears the burden of proving that its offsets were correct. Since both sides admit the validity of the net operating loss in 1982, taxpayer claims, the government must prove the investments were shams, nullifying the refund. In other words, he assumes that the offsets are in the form of an affirmative defense or counterclaim. Furthermore, he argues, this is only logical in that it is exceedingly difficult to prove that a bad investment was not a sham.

The government, in response, has the benefit of the caselaw. *Trust Services* is rather dispositive on the issue:

The government here bears a threshold burden of “going forward,” of establishing that its equitable setoff defenses to this tax refund suit are “made in good faith, rather than for improper purposes of deterrence and harassment.” ...Once the government has shouldered this burden, the taxpayer bears the burden of persuading the court that the deductions, exclusions or valuations in question were proper.

Id. at 566-67 (quoting *Ahmanson Foundation v. United States*, 674 F.2d 761, 777 (9th Cir. 1981)) (citations omitted). *Ahmanson* explains:

If the taxpayer bears the burden of proving the amount he is entitled to recover, then, as a general matter, the taxpayer should also have the burden with respect to all issues bearing upon the recovery amount—including the issues raised when the government asserts as a defense, in the nature of a setoff, the impropriety of some deductions previously allowed with respect to the same return.

Id. at 776-77. After setting out this threshold point, *Ahmanson* then goes on to say, as quoted by *Trust Services*, that the government must make some demonstration that its setoff claims are made in good faith. As long as it has done so, the taxpayer bears the burden. *See also United States v. Janis*, 428 U.S. 433, 440 (1976) (“In a refund suit, the taxpayer bears the burden of proving the amount he is entitled to recover.”).

Since the government clearly made a showing that this was a good faith offset and that taxpayer’s investments leading to credits and deductions was of dubious nature, it met its preliminary burden. We uphold the district court’s placement of the burden.

III. INVESTMENTS AS SHAMS

The government argues that the issue of whether the taxpayer met his burden of proving his entitlement to the deductions and credits presented factual issues, which we should review under the clearly erroneous standard. *Casebeer v. C.I.R.*, 909 F.2d 1360, 1362 (9th Cir. 1990). Yet that case mentions that this circuit's standard "appears inconsistent with Supreme Court authority, from which perhaps we should infer a de novo standard." *Id.* at 1362, n.6. As in *Casebeer*, we "reach the same result applying a de novo standard to the ultimate sham determinations." *Id.*

The test that we employ to determine whether investments are shams designed entirely for tax losses has both a subjective and an objective component. Subjectively, the taxpayer must have entered into the transaction with a bona fide business purpose other than tax avoidance. Objectively, the transaction must have been likely to produce economic benefits aside from tax benefits. *Id.* at 1363. This, however, is not a "rigid two-step analysis," *Id.*

Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses.

Id. (quoting *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824 (1988)).

A. Subjective Test

We first look to see if Cashman showed any business purpose other than tax avoidance in making his investments in the publishing and videotapes.

In the publishing ventures, Cashman claimed as investment tax credits \$22,700 for *The Triumph*, the mass-market

paperback, in 1978 and \$30,782 for "The Dover Collection" of books in 1979. Further, he deducted as net losses \$99,000 total for the former in 1978-79 and \$20,000 for the latter in 1979. As for the country and western music videotapes, he claimed as a credit in 1980 the sum of \$6,667, and in the same year he claimed \$75,000 as a loss.

His accountant testified that Cashman had asked him "to help him find tax sheltered investments," for which he specifically looked. Neither Cashman nor his accountant had any experience in publishing or music. Cashman could not produce copies of contracts, promissory notes, or canceled checks. As to the videotapes, Cashman did not even know who the performers on the tape were. The tape contained 5 songs, priced at \$20,000 each, a price he did not seek to get lowered, though that was possible. He did not see the tapes, nor did he know where they were kept. As the party on whom the burden rested, he did not provide any solid evidence to show that he subjectively expected this to be a profitable venture.

B. Objective Test

The government's witness, Gloria R. Mosesson, testified that the fair market value of the tapes and the publishing ventures was zero. Appellant's brief is devoted to an excoriation of the witness and her qualifications, instead of an attempt to argue for the value of his investments. In fact, while his brief is fifty pages in length, only briefly does he argue that these investments pass the objective test.

The brief is not wanting in length of discussion about the government witness, whom appellant refers to as unqualified. He also posits that the evidence on which she based her opinion was insufficient to justify her conclusions. It is unclear what he is appealing: the district court's misapplication

of the objective part of the test, its permitting this expert to testify, or the evidence of which she spoke. None of his jumbled allegations is tenable.

He insists that his investments need not have resulted in a profit, but rather that all he needed was a profit motive. This is not in dispute, though, and the government never argues a demonstrated profit is required. He claims that the expert was not versed in country and western music and therefore unknowledgeable about his videotape venture. While she admittedly did not walk into court whistling Loretta Lynn tunes, she had spent ~~over~~ 30 years as an editor, in supervising production and promotion of books, and in negotiating publishing, audio, and video rights. Further, the fact that she had testified for the IRS over the past five years is not a black mark against her qualifications as an expert; in fact, it is probably the reverse.

In addition, appellant stresses that the promissory note involving the videotapes was recourse, from which he argues that the court should have inferred legitimacy. Neither was this note ever paid, nor did the owner of the videotape venture state that the note was even important to him. This one piece of evidence is not dispositive on the objective test.

Appellant concludes this section of his brief with the contention that it was error for the court to rely on the expert witness as a principal support for the court's judgment. As noted above, only briefly does appellant directly argue that the investments were legitimate. He mentions that the two artists on the music videotapes were country and western stars, yet he admitted never having heard of them. He talks in similar glowing terms about the publishers, but those books were explained to be worthless. His only substantive reasoning is that the court failed to reopen discovery, thus depriving him of the opportunity to secure evidence to support the legitimacy of the investments.

We conclude that the taxpayer did not meet his burden of proving that the investments were made with a profit motive or that they had economic substance.

IV. DISCOVERY

We review the district court's rulings concerning discovery for an abuse of discretion. *Ah Moo v. A.G. Becker Paribas, Inc.*, 857 F.2d 615, 619 (9th Cir. 1988).

Discovery was originally opened from January 16, 1985, to August 15, 1986, then from January 23, 1987, to April 23, 1987, and again from August 21, 1987, to October 20, 1987. Appellant claims that when the pretrial order was extended to January 15, 1988, he assumed discovery was also extended. Prior to that date, he argues, he had not known what he needed to discover and thus afterward asked the district court for another extension.

The district court refused to grant such, finding that taxpayer had not exercised due diligence in pursuing his discovery needs in this case. Such a reopening, it held, would work a hardship on the government. Appellant raises no strong argument why the district court erred in not opening discovery, let alone abused its discretion in not doing so. We uphold the denial.

V. EXPERT WITNESS

We will not reverse a trial court's decision to exclude expert testimony unless it is "manifestly erroneous." *Taylor v. Burlington N. R.R. Co.*, 787 F.2d 1309, 1315 (9th Cir. 1986).

Cashman advised defense counsel on April 25, 1989, that he intended to use as an expert witness, James McPhee, a librarian at the University of Nevada. This was necessary, he argues, because another witness, who had been previously

lined up, refused to come to Las Vegas from New York. The court denied the right to use this witness on the grounds that he had not been identified prior to the pretrial order of October 1987.

Refusal to permit the testimony of a witness who was not mentioned until 18 months after the pretrial order is not manifestly erroneous. We affirm.

VI. CONCLUSION

We affirm the district court both because the statute of limitations does not bar the offsets and because the investment tax credits and deductions were rightfully disallowed. **AFFIRMED.**



APPENDIX E

[Filed September 20, 1991]

NOT FOR PUBLICATION

United States Court of Appeals

FOR THE NINTH CIRCUIT

MORGAN CASHMAN,

Plaintiff-Appellant,

v.

UNITED STATES
OF AMERICA,

Defendant-Appellee.

No. 90-15806

D.C. No.

CV-85-0028-PMP

O R D E R

BEFORE: D.W. NELSON, KOZINSKI AND T.G. NELSON, CIRCUIT JUDGES.

The members of the panel that decided this case voted unanimously to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. (Fed.R. App. P. 35.)

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX F

STATUTES INVOLVED

IRC § 1311. CORRECTION OF ERROR.

(a) **General Rule.**—If a determination (as defined in section 1313) is described in one or more of the paragraphs of section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error shall be corrected by an adjustment made in the amount and in the manner specified in section 1314.

IRC § 1314. AMOUNT AND METHOD OF ADJUSTMENT.

(c) **Adjustment Unaffected by Other Items.**—The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this part, shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment. The amount of the adjustment under this part, if paid, shall not be recovered by a claim or suit for refund or suit for erroneous refund based upon any item other than the one which was the subject of the adjustment.

FEDERAL RULES OF CIVIL PROCEDURE

RULE 15(b)

Amendments to Conform to the Evidence.—When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of

these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court may allow the pleadings to be amended and shall do so freely when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. The court may grant a continuance to enable the objecting party to meet such evidence.